Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: June 20, 2024—9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed relatively unchanged. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 1.8%. US equity index futures are signaling a higher open.

The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

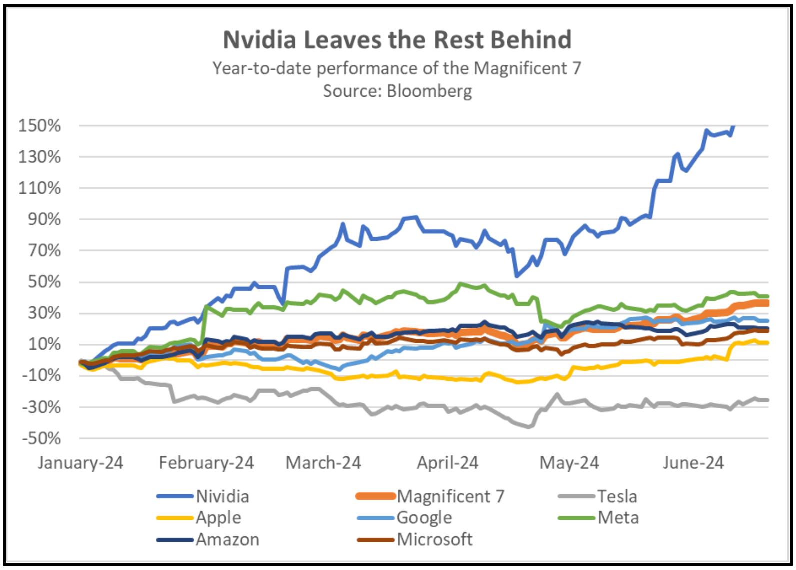
- *Bi-Weekly Geopolitical Report* (6/17/2024) (with associated podcast): "Mid-Year Geopolitical Outlook: Uncertainty Reigns"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance Presentation* (5/7/2024): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Asset Allocation Bi-Weekly* (6/10/2024) (with associated podcast): "Copper, Gold, Treasurys, and the New World"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"
- *Fixed Income Quarterly* (June 2024)

Good morning! Equities are starting the day strong despite another round of disappointing economic data. In sports, Texas A&M dominated Florida, bringing them closer to clinching the College World Series title. Today's *Comment* will explore why Nvidia's momentum may wane, discuss the renewed investor interest in the US dollar, and explain the latest rate decision from the Bank of England. As always, we conclude with a roundup of international and domestic news.

Hype Keeps Growing: Nvidia's stock price keeps climbing, but there's growing worry that the current enthusiasm might not be sustainable.

- The US chip designer overtook Microsoft as the world's most valuable company on Tuesday. This rise is fueled by the ongoing excitement surrounding artificial intelligence (AI), which continues to captivate investors. The company's recent strong performance is partly due to its decision to split its stock 10-to-1. This move made the shares more affordable for retail investors, increasing their accessibility. Nvidia sits at the forefront of the AI revolution, controlling an estimated 80% of the market for AI-specific chips. This takeover marks a historic shift, with the top spot last held by a non-Microsoft or Apple company being claimed by Cisco in 2000.

- While Nvidia's stock soars, the momentum has not carried over to other AI-related stocks. Nearly 60% of the companies within the S&P 500 have seen gains this year, while more than half the stocks in Citi's "AI Winners Basket" have seen a decline. The problem may be related to valuation. The "Magnificent Seven," a group of prominent tech companies, trade at a significant premium compared to their large-cap peers. Their average price-to-equity ratio is a hefty 36.6, compared to 21.6 for the S&P 500 when those seven stocks are excluded.

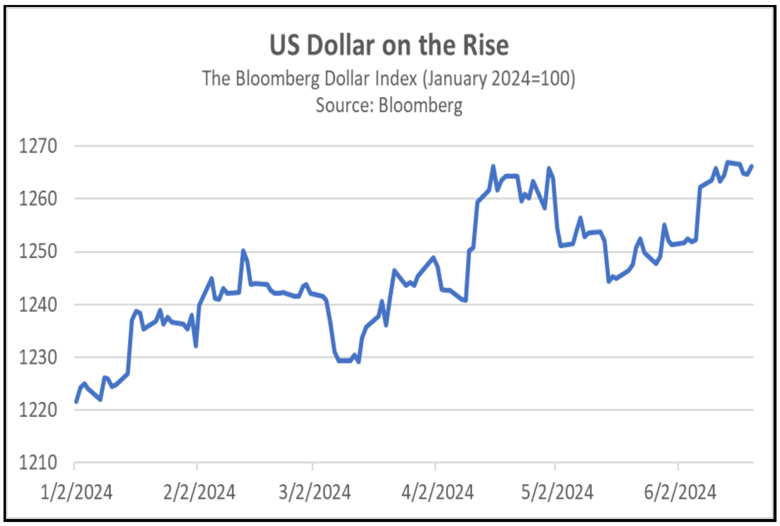


- AI's rising popularity is being met with increasing regulatory hurdles. The US is taking further steps to curb China's chipmaking capabilities by limiting access to advanced chips. This week, a White House official will meet with counterparts from Japan and the Netherlands to discuss stricter chip export restrictions to China. Domestically, US antitrust watchdog and FTC Chair Lina Khan has announced her intentions to prevent large tech firms, particularly in the AI space, from further expansion. Earlier this year, she blocked the proposed Nvidia-ARM merger, which would have been the largest ever in the semiconductor industry, citing concerns that it would stifle innovation.

The Dollar Comeback: The Bloomberg Dollar Spot Index is on the verge of setting a new high for the year as investors view the US currency as being safer than its European counterpart.

- The US dollar has risen sharply since May. Investors are seeking the greenback due to rising uncertainty in the eurozone. Earlier this month, the European Central Bank cut its benchmark policy rates by 25 basis points, despite signs that inflation might be about to resurge. Meanwhile, the Federal Reserve surprised markets with a hawkish turn, despite evidence suggesting that inflationary pressures are easing. These contrasting policy moves have widened interest rate differentials, as investors rotate out of European bonds and into US Treasurys, in a sign that they are growing confident in America's ability to control inflation.

- Political uncertainty has bolstered the US dollar, with French elections set to take place in 10 days. There is widespread concern that populist parties will win a significant number of seats, which is fueled by the rising popularity of the National Rally party and a potential coalition of left-wing populist movements that could gain control of parliament. Although French President Emmanuel Macron's position is not on the ballot, the election may act as a referendum on his presidency, potentially rendering him a lame duck if his party suffers a serious defeat. A populist victory could see a slowdown or even a reversal of some of his pro-market reforms.

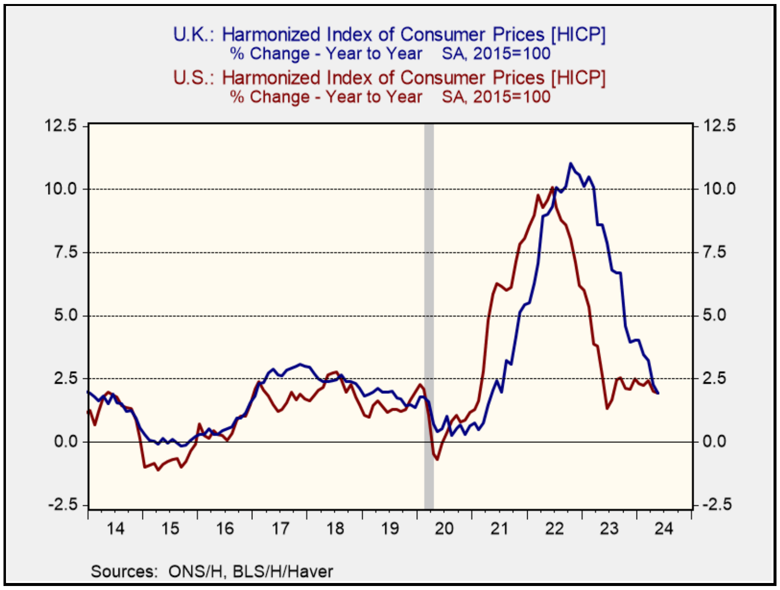


- Although the dollar has some momentum, concerns over US growth could prevent it from a breakout. The latest retail sales data suggests that consumers are starting to become price sensitive, while the labor market has shown signs of cooling. This weakness may lead investors to price in another rate cut for the year, rather than just the one that the Fed outlined in its summary of economic projections. Additionally, a less disruptive than expected election outcome could entice investors back to European markets. Consequently, the dollar may enter a holding pattern in the coming weeks as investors seek greater clarity.

No Action in the UK: The Bank of England held rates steady at its latest meeting despite inflation falling to target in May.

- The BOE kept its key policy rate at a 16-year high of 5.25%. The decision not to move was not unanimous, as two members of the committee voted in favor of a cut. While inflation did return to 2% in May, policymakers signaled concerns that service inflation and wage pressures remained a problem and could hinder the central bank's target of maintaining price stability, while others showed that elevated components of the reports were likely temporary. That said, the committee seems to be satisfied with the level of inflation progress.

- The BOE's cautious approach mirrors the Fed's latest decision from earlier this month. Both central banks expressed concerns about a potential resurgence of inflation in the second half of the year during their explanations for their recent actions. [The BOE's meeting minutes] stated that they believe price pressures may rise later in the year as energy prices stop acting as a drag on the inflation index. Meanwhile, [Fed Chair Jerome Powell argued that the rollover impact] of the core PCE price index could also cause the Fed's preferred inflation measure to increase due to these temporary effects. However, both central banks maintained that a cut is still likely this year.

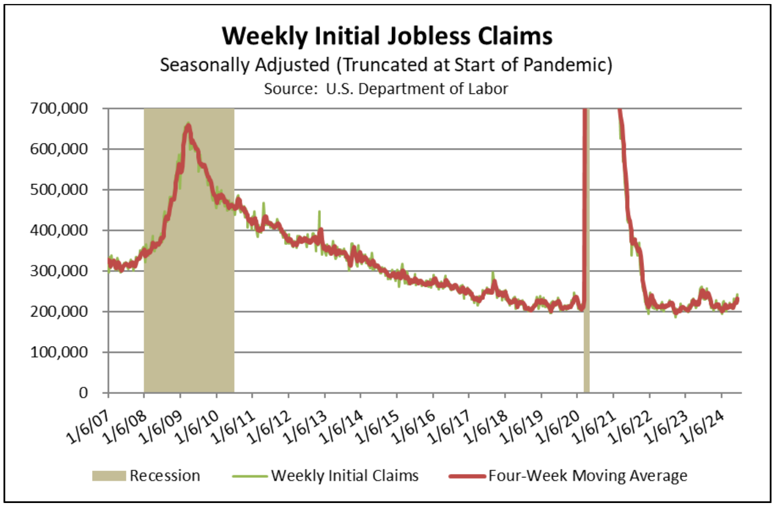


- The possibility of rate cuts in late summer or early fall remains on the table for both the BOE and the Fed. The chart above shows that when inflation is adjusted for comparison with other countries (harmonized inflation), UK inflation is roughly in line with US inflation. However, it's important to note that recent declines are largely due to falling energy prices, which may not reflect the underlying trend in other parts of the economy. Reflecting this concern, the Bank of England may consider a cut in August, while the Federal Reserve will likely wait for data releases, particularly inflation reports from July and August, before deciding on a September rate cut.

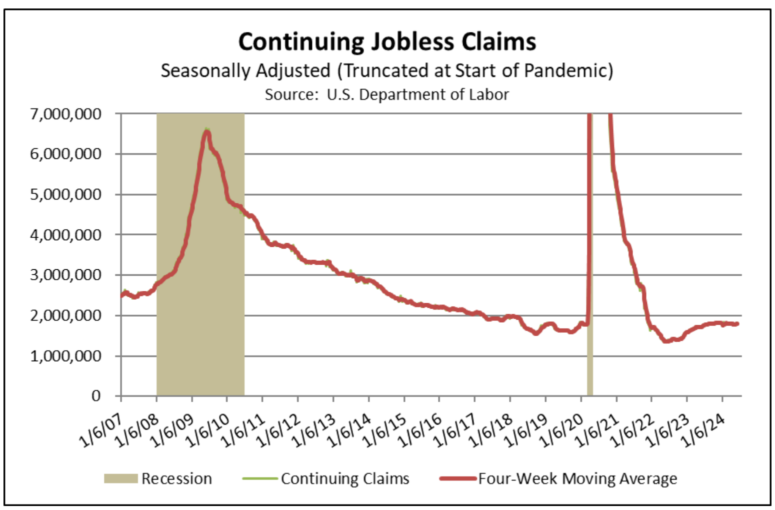
In Other News: In a move to counter isolation by the US, [Russia signed a mutual defense treaty with North Korea]. This highlights Russia's efforts to forge alliances with countries opposing the West, potentially to bolster its war effort in Ukraine. Meanwhile, [Dutch Prime Minister Mark Rutte was selected as the new head of NATO], and his seamless transition will likely help the military alliance maintain unity as it looks to take on threats from Russia and China.

US Economic Releases

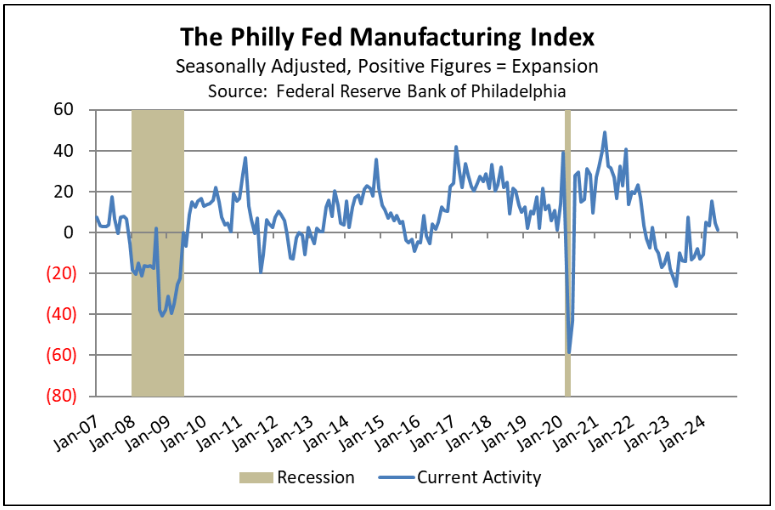
In the week ended June 15, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 238,000, higher than the expected level of 235,000 but below the prior week's revised level of 243,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 232,750, its highest since last September. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



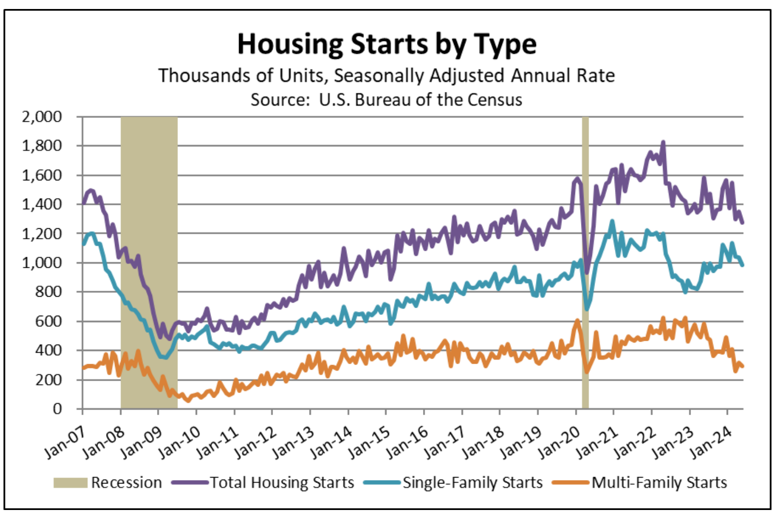
In the week ended June 8, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.828 million, above both the anticipated reading of 1.810 million and the previous week's revised reading of 1.813 million. The four-week moving average of continuing claims rose to 1,805,500. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



Separately, the Philadelphia FRB said its June ***Philly Fed Index*** fell to a seasonally adjusted 1.3, well short of both the expected reading of 5.0 and the May reading of 4.5. The index, officially called the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing is still growing, but only slightly. The chart below shows how the index has fluctuated since just before the GFC.



Finally, May ***housing starts*** fell to a seasonally adjusted, annualized rate of 1.277 million units, short of both the expected rate of 1.370 million units and the revised April rate of 1.352 million. The rate of housing starts in May was down 5.5% from the rate in the previous month. Also in the report, May ***housing permits*** fell to an annualized rate of 1.386 million units, falling short of their anticipated rate of 1.450 million units and the April rate of 1.440 million. Permits issued for new housing units in May were down 3.8% from the previous month. Compared with the same month one year earlier, housing starts in May were down a whopping 19.9%, while permits were down 9.4%. In each case, the fall mostly came from the multi-family sector. The chart below shows the growth in new home starts by type of property since just before the GFC.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases		
	No economic releases for the rest of today	
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
8:45	Neel Kashkari Participates in Fireside Chat	President of the Federal Reserve Bank of Minneapolis
16:00	Thomas Barkin Speaks on Economic Outlook	President of the Federal Reserve Bank of Richmond
22:15	Mary Daly Participates in Panel Discussion on AI	President of the Federal Reserve Bank of San Francisco

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications, and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Trade Balance	y/y	May	-¥465.6b	-¥462.5b	-¥1280.5b	**	Equity and bond neutral
	Exports	y/y	May	0.1	0.1	0.1	*	Equity and bond neutral
	Imports	y/y	May	0.1	0.1	0.1	*	Equity and bond neutral
	Tokyo Condominiums for Sale	y/y	May	-19.9%	-42.5%		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	14-Jun	-¥108.4b	-¥346.2b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	14-Jun	¥80.0b	¥404.4b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	14-Jun	-¥235.8b	-¥2648.6b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	14-Jun	¥653.6b	-¥2647.6b		*	Equity and bond neutral
New Zealand	GDP	y/y	1Q	0.3%	-0.2%	0.2%	***	Equity and bond neutral
EUROPE								
Eurozone	Current Account	m/m	Apr	38.6b	35.8b		*	Equity and bond neutral
	Construction Output	y/y	Apr	-1.1%	-0.7%		*	Equity and bond neutral
	EU27 New Car Registrations	y/y	May	-3.0%	13.7%		***	Equity and bond neutral
Germany	PPI	y/y	May	-2.2%	-3.3%	-2.0%	**	Equity and bond neutral
Italy	Current Account Balance	m/m	Apr	2294m	1500m		*	Equity and bond neutral
UK	CPI	y/y	May	2.0%	2.3%	2.0%	***	Equity and bond neutral
	CPI Core	y/y	May	3.5%	3.9%	3.5%	***	Equity and bond neutral
	Retail Price Index	m/m	May	386.4	385.0	387.0	**	Equity and bond neutral
	RPI	y/y	May	3.0%	3.3%	3.1%	**	Equity and bond neutral
	House Price Index	y/y	Apr	1.1%	0.9%		*	Equity and bond neutral
Switzerland	Real Exports	m/m	May	-3.5%	7.0%		*	Equity and bond neutral
	Real Imports	m/m	May	-4.3%	3.2%		*	Equity and bond neutral
Russia	Consumer Confidence	q/q	2Q	-6	-7		***	Equity and bond neutral
	PPI	y/y	May	16.2%	18.4%	15.7%	***	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	Apr	3.2%	-1.7%	1.0%	***	Equity bullish, bond bearish

Financial Markets

The table below highlights some of the indicators that we follow daily. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	561	561	0	Up
3-mo T-bill yield (bps)	523	524	-1	Up
U.S. Sibor/OIS spread (bps)	535	535	0	Up
U.S. Libor/OIS spread (bps)	534	535	-1	Up
10-yr T-note (%)	4.25	4.22	0.03	Up
Euribor/OIS spread (bps)	371	372	-1	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	5.250%	5.250%	5.250%	On Forecast
Swiss National Bank Policy Rate	1.250%	1.500%	1.500%	Below Forecast
PBOC 1-Year Loan Prime Rate	3.450%	3.450%	3.450%	On Forecast
PBOC 5-Year Loan Prime Rate	3.950%	3.950%	3.950%	On Forecast
Brazil Selic Rate	10.500%	10.500%	10.500%	On Forecast

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.32	$85.07	0.29%	
WTI	$81.70	$81.57	0.16%	
Natural Gas	$2.84	$2.91	-2.23%	
12-mo strip crack	$22.13	$22.41	-1.26%	
Ethanol rack	$2.11	$2.11	0.04%	
Metals				
Gold	$2,339.00	$2,327.71	0.49%	
Silver	$30.27	$29.79	1.62%	
Copper contract	$448.45	$445.05	0.76%	
Grains				
Corn contract	$464.75	$467.75	-0.64%	
Wheat contract	$593.50	$599.00	-0.92%	
Soybeans contract	$1,127.75	$1,132.00	-0.38%	
Shipping				
Baltic Dry Freight	1,943	1,961	-18	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.80		
Gasoline (mb)		1.05		
Distillates (mb)		1.05		
Refinery run rates (%)		0.0%		
Natural gas (bcf)		68		

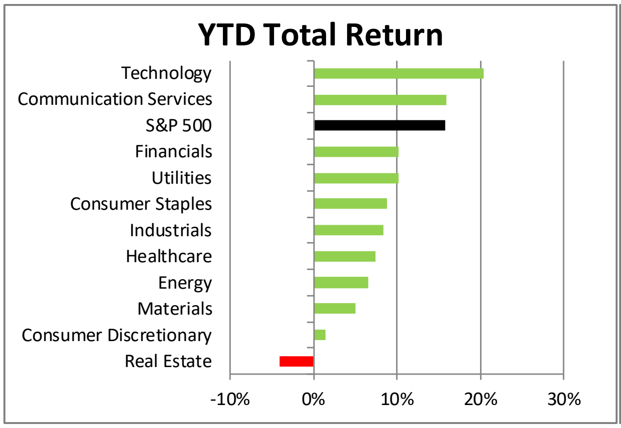
Weather

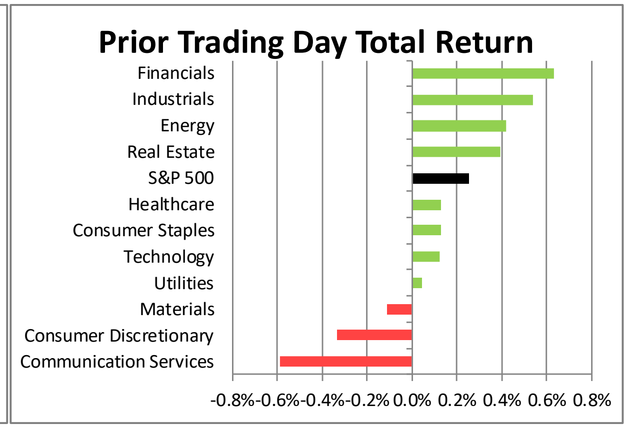
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire country except for the Pacific Northwest, where cooler-than-normal temperatures are expected. The forecasts call for wetter-than-average conditions in the Pacific Northwest, the Great Plains, and the Deep South, with dry conditions expected in California and Nevada.

There are currently three tropical disturbances in the Atlantic Ocean region. Tropical Storm Alberto has now reached Mexico and is heading inland due west. It is expected to produce rainfall and strong winds as far north as southern Texas. A second disturbance, located north of the Bahamas, is moving northwestward toward the southeastern US and is assessed to have a 40% chance of turning into a cyclone. The final disturbance, off the Yucatan Peninsula, is moving northwesterly toward Guatemala; it is assessed to have only a 20% chance of turning into a cyclone.

<u>Data Section</u>

US Equity Markets – (as of 6/18/2024 close)

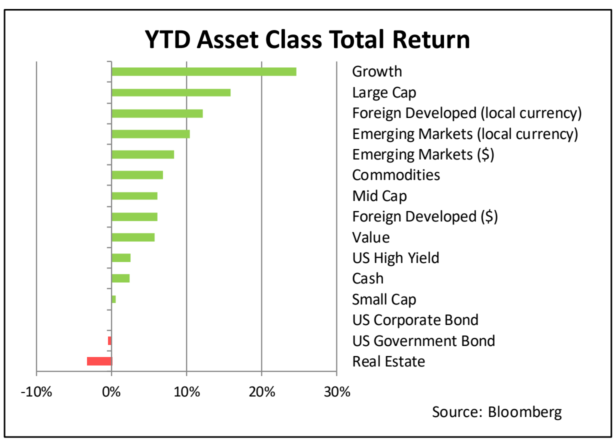




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 6/18/2024 close)

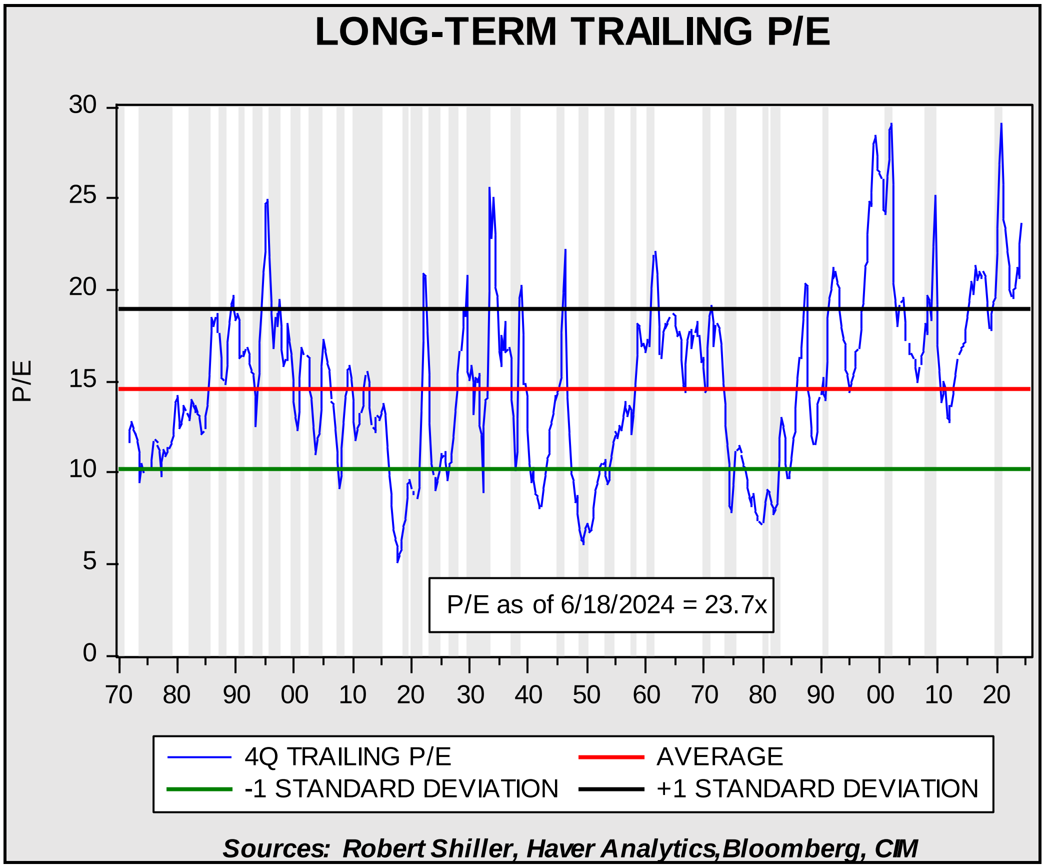


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), US Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), US Government Bond (iShares 7-10 Year Treasury Bond ETF), US High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index), Value (S&P 500 Value), Growth (S&P 500 Growth).

P/E Update

June 20, 2024



Based on our methodology,[1] the current P/E is 23.7x, up 0.1 from our last report. The increase in the multiple was due to an increase in the stock price index, and a slight decline in Q1 earnings.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the Bloomberg estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes three actual quarters (Q1, Q2 and Q3) and one estimate (Q2). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a long-term dataset for P/E ratios.